Overview

Spain: The cost of doubt

Uncertainties surrounding banks' bailout are costly for Spain. Spain's 10-year spread over Germany exceeds 500 basis points, compared with half that a year ago. Above all, it is the lack of visibility that undermines investors' confidence. They are clearly reluctant to fund a recapitalisation if they don't know the extent of the whole problem. Yet, even if the government undertook the complete recapitalisation of the banking sector, and assuming it amounted to €100bn, that would represent 10% of GDP, far short of the 45% of GDP needed in Ireland. It would be definitely better to get an accurate and final estimation from an independent body of the total bill for bailing out Spanish banks than getting gradual and partial news.

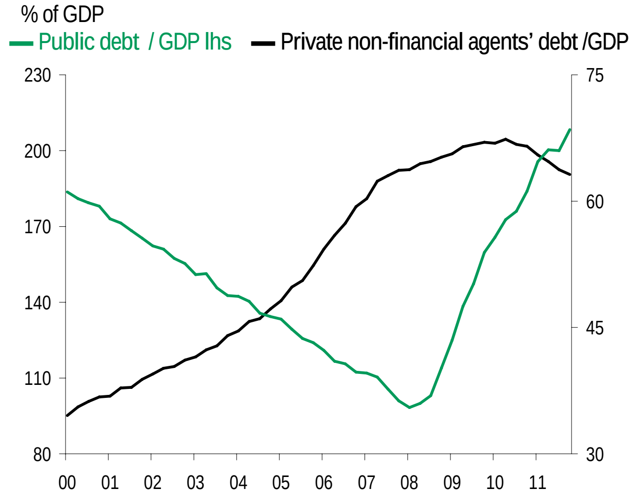
Taken as a whole, Spanish debt is the same as two years ago (around 260% of GDP). The catch is that its composition has changed (see chart). Transfers of debt from the private to the public sector (and vice versa) are a classic phenomenon. When activity falls, it is usual to see the government taking over from private demand via stimulus programmes or simply via automatic stabilisers, with lower receipts and higher spending reflecting a smaller tax base and increased unemployment. In this case, a wider public sector deficit creates a window of opportunity for the private sector to consolidate its finances, and the latter's subsequent expansion permits a return to budgetary equilibrium. This two-stage 'communicating vessel' arrangement works without putting pressure on bond markets, so long as the markets expect a reduction in t+1 of the government deficits posted at t. And that means credible fiscal consolidation at the point where activity is robust enough to cope with it.

Despite a possible one-year deadline extension granted by the European Commission, the deficit reduction timetable for Spain looks too short. This results from both a lack of economic and political coordination within Europe and the European partners' lack of confidence in each other. In spite of drastic austerity in Spain's 2012 budget, automatic stabilisers are still weighing heavily on the government's accounts and still unresolved problems in the banking sector are pushing up sovereign risk.

Against this backdrop, Bankia's recapitalisation is something of a test, even though the amount involved is relatively modest (€19bn, or less than 2% of GDP) and Spanish government debt represents 'only' 70% of GDP. Here, too, the issue is one of credibility. It is unlikely that the Spanish banking sector's difficulties are restricted to a single institution or that losses are concentrated exclusively in assets related to the property market.

To avoid tapping the markets, officials proposed a recapitalisation through a direct injection of sovereign bonds into BFA (Bankia's parent company) in return for a public equity stake.

A zero-sum game



Chart

Source: ECB

Using the bonds as collateral, BFA could then obtain funding from the ECB and subscribe to the Bankia capital increase. Unsurprisingly, the ECB was hostile to the plan, as it would effectively mean direct central bank funding for the Spanish government.

It seems instead that the Bankia recapitalisation will probably involve the Fund for Orderly Bank Restructuring (FROB) created in 2009, which would issue bonds guaranteed by the Spanish State. This solution would necessarily prove costly, making further public recapitalisation initiatives – a likely prospect – more difficult. The alternative would be a request for European financial support from the EFSF and ESM (the latter is to be activated on 1 July), as these funds are available specifically for bank recapitalisation. But the aid request would have to come from the government. For now, this option appears to be politically unacceptable. This is one of the weaknesses of Europe's response to the crisis. Appeals to financial support create stigma and fail to restore investors' confidence. Greece, Ireland and Portugal waited until their backs were against the wall before calling for help. Inevitably this means a greater financial and social cost in the end, and for both lenders and borrowers.